United States District Court
Northern District of California

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN JOSE DIVISION

CITY OF BIRMINGHAM RELIEF AND RETIREMENT SYSTEM,

Plaintiff,

v.

REED HASTINGS, et al.,

Defendants.

Case No. 18-cv-02107-BLF

ORDER GRANTING MOTION TO DISMISS WITH LEAVE TO AMEND

[Re: ECF 30]

Plaintiff City of Birmingham Relief and Retirement System ("Birmingham") brings this stockholder derivative action on behalf of nominal defendant Netflix, Inc. against current and former directors and executive officers for alleged violations of securities laws, breaches of fiduciary duty, and corporate waste as a result of their purported knowledge of an alleged scheme to illegally rig Netflix's performance-bonus compensation plan. Compl., ECF 1. Birmingham alleges that these illegal actions caused Netflix to pay excessive fees to certain officers, to suffer reputational damage, and to expose itself to potential tax penalties and fines.

Presently before the Court is Defendants'[1] motion to dismiss Birmingham's complaint for failure to plead demand futility under Federal Rule of Civil Procedure 23.1 and failure to state a claim under Rule 12(b)(6). *See generally* Mot., ECF 30. The Court heard argument on this motion on December 13, 2018. For the reasons stated herein, the Court GRANTS Defendants' motion WITH LEAVE TO AMEND.

[1] "Defendants" refers to Reed Hastings, David Wells, Richard Barton, A. George (Skip) Battle, Timothy Haley, Jay Hoag, Leslie Kilgore, Ann Mather, Brad Smith, Anne Sweeney, Neil Hunt, Ted Sarandos, Greg Peters, and David Hyman. *See generally* Compl.

I. BACKGROUND

A. The Parties

City of Birmingham Relief and Retirement System ("Birmingham") is an institutional shareholder of nominal Defendant Netflix, Inc. ("Netflix" or the "Company"). Compl. ¶¶ 15, 108. Netflix is a Delaware Corporation with its principal place of business in Los Gatos, California. *Id.* ¶ 16. The Complaint names several of Netflix's officers as defendants. Defendant David Wells has been Netflix's Chief Financial Officer since 2010. *Id.* ¶ 18. Defendants Neil Hunt (former-Chief Product Officer), Ted Sarandos (Chief Content Officer), Greg Peters (current-Chief Product Officer, former-International Development Officer), and David Hyman (General Counsel) (collectively with Wells, "Officer Defendants") each received compensation pursuant to Netflix's allegedly unlawful performance-bonus compensation plan, as described in more detail below.

The Complaint also names nine directors on Netflix's board of directors as defendants (collectively, the "Director Defendants"): Reed Hastings, Richard Barton, A. George (Skip) Battle, Timothy Haley, Jay Hoag, Leslie Kilgore, Ann Mather, Brad Smith, and Anne Sweeney. *Id.* ¶¶ 17, 19–26. Hastings is Netflix's Chief Executive Officer and is not "independent" under SEC and NASDAQ rules. *Id.* ¶ 17. During the relevant time period, Battle, Haley, and Hoag (collectively, "Compensation Committee")[2] served on the Board's Compensation Committee, which is responsible for reviewing and approving compensation of the Company's executive officers and directors, administering the Company's performance-bonus compensation plan, and preparing a report for the Company's proxy statements, which includes a compensation discussion and analysis ("CD&A") that the Committee recommends to the Board for inclusion in the proxies. *Id.* ¶¶ 20–26, 48. Each Director Defendant owes Netflix and its shareholders fiduciary duties of trust, loyalty, good faith, and candor. *Id.* ¶¶ 35–42.

B. Section 162(m) and the Performance-Bonus Compensation Plan

In March 2014, the Compensation Committee Defendants developed and approved a performance-bonus compensation plan ("the Plan") for compensating its top executives, which

[2] The Complaint also alleges that Sweeney served on the Compensation Committee, but it excludes her from the allegations relevant to that Committee's activities. *See* Compl. ¶¶ 26, 29.

shareholders approved in June 2014. *Id.* ¶¶ 56–59. The Plan was designed in part to permit the Company to claim a tax deduction for performance-based compensation pursuant to 26 U.S.C. § 162(m) ("Section 162(m)"). *Id.* ¶¶ 56–58. Section 162(m) generally bars tax deductions on compensation of certain high-paid executives in excess of one million dollars. *Id.* ¶¶ 50–51. Congress enacted this one-million-dollar deduction cap "to prevent excessive compensation and to align the performance incentives of certain company executives with the interests of shareholders." *Id.* ¶ 55 (citing JCS-3-03 NO 16, 2003 WL 25599037, at 133 n.2211 (Feb. 2013)); *see* H.R. Rep. No. 103-111, at 646 (1993). But, at the relevant time, Section 162(m) contained an exception for compensation awarded for "the attainment of one or more performance goals."[3] 26 U.S.C. § 162(m)(4)(C) (2017); Compl. ¶¶ 52–53. To be tax deductible, the performance-based compensation had to be determined by a compensation committee, disclosed to shareholders, and approved by a majority of the vote in a separate shareholder vote, among other things. 26 U.S.C. § 162(m)(4)(C). The compensation also had to be "paid solely on account of the attainment of one or more preestablished, objective performance goals." 26 C.F.R. § 1.162-27(e)(2)(i). To be preestablished, the performance goal must have been "substantially uncertain at the time the compensation committee actually establishe[d] the goal." *Id.*

The Plan was first implemented in 2015. Compl. ¶¶ 60. Birmingham alleges that despite its stated intent, the Plan was never meant to comply with Section 162(m) because the performance goals set by the Compensation Committee and approved by the Board were never "substantially uncertain," as required under Section 162(m) to be tax deductible. Before each quarter in 2015, 2016, and 2017, the full Board received quarterly projections of Netflix's global streaming revenue. *Id.* ¶¶ 83, 86, 88, 91, 94, 97, 99, 102, 104, 107. Birmingham alleges that these projections were highly accurate "because [they] had a short time horizon (*i.e.*, only a few months) and because, as a subscription-based service, Netflix had significant insight into its near-term streaming revenue based on the number of paid subscribers it had signed up."[4] *Id.* ¶ 6.

[3] Section 162(m) was later amended to remove this exception.

[4] Birmingham requests the Court take judicial notice of a document compiling data from Bloomberg regarding Netflix's earnings history, which was "extracted from Netflix's various SEC filings." *See* Laughlin Decl. ISO Opp. ¶ 2, ECF 37-2; Opp. at 8 n.4. Defendants oppose this

Soon thereafter in each quarter, the Compensation Committee would set a performance period of three months (*i.e.*, one quarter) and set specific performance goals for quarterly global streaming revenue. *Id.* ¶¶ 80, 82, 85, 87, 90, 93, 96, 98, 101, 104, 106–07; *see also id.* ¶ 16. Each of the quarterly goals was lower than or substantially similar to the projections previously provided to the Board. *Compare, e.g.*, Compl. ¶ 83 (projection of [redacted]) *with id.* ¶ 82 (target of $1,474,000,000); *id.* ¶ 86 (projection of [redacted]) *with id.* ¶ 85 (target of $1,593,000,000); *id.* ¶ 91 (projection of [redacted]) *with id.* ¶ 90 (target of $1,813,000,000). Moreover, bonuses were to be paid if the Company achieved at least 80% of the chosen performance target. *Id.* ¶ 61.

Each quarter, the Compensation Committee also certified the payment of bonuses for the previous quarter based on whether the Company had achieved the preestablished performance goals. Each quarter's global streaming revenue turned out to be substantially similar to the performance goals the Compensation Committee had set for that quarter. *Compare, e.g.*, Compl. ¶ 81 (goal of $1,398,000,000) *with id.* ¶ 81 (outcome of $1,399,929,000); *id.* ¶ 87 (goal of $1,593,000,000) *with id.* ¶ 87 (outcome of $1,580,830,000); *id.* ¶ 92 (goal of $1,813,000,000) *with id.* ¶ 92 (outcome of $1,812,989,000). By July 2017, each goal in seven out of eight quarters had been achieved "squarely," with the eighth being missed by just one percentage point. *Id.* ¶ 7; *see also id.* ¶¶ 8, 70, 71, 76, 77. Officer Defendants Sarandos, Hunt, Peters, and Hyman were awarded bonuses pursuant to the Plan. *See, e.g.*, *id.* ¶ 106.

C. The Associated Proxies

Netflix issued proxy statements in 2015, 2016, and 2017 that each included information regarding the Plan. Birmingham claims that each of these proxies was misleading in its description of the Plan as intending to comply with Section 162(m) and that the Board knowingly authorized the issuance of each of the proxies.

On March 18, 2015, the Compensation Committee Defendants held a meeting, during

request. Reply at 6 n.1. The Court agrees with Defendants that judicial notice of this compilation document from unidentified sources is not appropriate, particularly as Birmingham asks the Court to take notice of the truth of the contents of the document.

which they reviewed Section 162(m) and decided to implement the Plan "to allow the Company to take advantage of available tax deductions." Compl. ¶¶ 46, 60. The Committee approved the Compensation Disclosure & Analysis ("CD&A") for inclusion in the Company's 2015 proxy statement ("2015 proxy") to reflect the implementation of the Plan. *Id.* ¶ 46. That same day, the full Board met and received a report from Compensation Committee Defendant Haley. The report provided the "[Compensation] Committee's discussion of (1) the performance bonus plan and tax implications under 162(m) of the IRS Code and (2) the compensation disclosures to be made in the upcoming proxy, including updates to the Company's compensation disclosure and analysis." *Id.* The Board then authorized the filing of the 2015 proxy, which Defendant General Counsel Hyman issued "by order of the Board of Directors." *Id.* ¶¶ 42, 46, 62. The 2015 proxy stated, in relevant part:

> Additionally for 2015, certain of the Named Executed Officers [*i.e.*, the Executive Officer Defendants] participate in the Company's Performance Bonus Plan (the "Plan"). As discussed below, salary for each Named Executive Officer, other than the Chief Financial Officer, that is over $1 million has a substantial surcharge to the Company under IRS rule 162(m). *In order to comply with 162(m)*, the Company created, and the stockholders approved, the Plan and the Company has implemented it for those whose salary the Company wants to cap at $1 million to avoid the surcharges. For 2015, the Named Executive Officers, except for the Chief Executive Officer and Chief Financial Officer, will participate in the Plan.

Id. ¶ 64; *see also id.* ¶ 65 (recounting 2015 proxy's statement that Plan was "performance-based")

The following year, on March 16, 2016, the Compensation Committee Defendants again held a meeting to review Section 162(m) and discuss the Plan and its compliance with Section 162(m), as well as changes to the CD&A with respect to the Plan and the bonus payments made in 2015. *Id.* ¶ 46. Thereafter, the Board "order[ed]" Defendant Hyman to issue the 2016 proxy. *Id.* ¶ 69. The following year, the Board "caused Netflix to issue" the 2017 proxy, which was substantially similar in relevant part to the 2016 proxy. *Id.* ¶ 75. Both proxies stated that the Plan was "intended" to comply with Section 162(m), and that the Plan was "intended to permit the Company to seek a full federal tax deduction for compensation paid under the Plan, compensation that otherwise might not be fully tax deductible to the Company if paid as salary." *Id.* ¶¶ 69, 75. They also detailed the performance goals the Committee had set for the previous year's quarters

and the results for global streaming revenue that the Company had achieved during those same time periods. *Id.* ¶¶ 69, 75.

Birmingham alleges that these proxies were misleading because they described the Plan as being intended to comply with Section 162(m) and as being "performance-based" when in fact the Plan was designed to wrongfully exploit the tax deductions provided by Section 162(m). *Id.* ¶¶ 66, 72, 78. According to Birmingham, the proxies caused shareholders to approve paying more than $27 million in unnecessary bonuses and misled investors about the way in which executive compensation was calculated and the potential tax liability incurred under Section 162(m). *Id.* ¶¶ 40, 111.

D. Procedural Background

Birmingham filed the instant derivative action on April 6, 2018. *See* Compl. In its Complaint, Birmingham brings three claims: (1) Violation of §14(a) of the Securities Exchange Act of 1934 for the allegedly misleading proxies; (2) Breach of Fiduciary Duty for violations of federal securities and U.S. tax laws and the company's internal governance regulations; and (3) Corporate Waste, for excessive payments made pursuant to the Plan that were not tax deductible. *Id.* ¶¶ 117–30.

II. LEGAL STANDARD

A. Federal Rule of Civil Procedure 23.1

Federal Rule of Civil Procedure 23.1 governs derivative actions, *see Rosenbloom v. Pyott*, 765 F.3d 1137, 1148 (9th Cir. 2014), and requires a plaintiff to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Fed. R. Civ. P. 23.1(b)(3). While Rule 23.1 involves the adequacy of a plaintiff's pleadings, "[t]he substantive law which determines whether demand is, in fact, futile is provided by the state of incorporation of the entity on whose behalf the plaintiff is seeking relief." *Rosenbloom*, 765 F.3d at 1148 (internal citation omitted).

Netflix is a Delaware corporation, and Delaware law therefore controls. *See Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90, 108–09 (1991) ("[A] court that is entertaining a derivative

action . . . must apply the demand futility exception as defined by the State of incorporation.”).

In the context of a pre-suit demand, directors are entitled to a presumption that they fulfilled their fiduciary duties, and “the burden is upon the plaintiff in the derivative action to overcome that presumption” with particularized factual allegations. *Beam v. Stewart*, 845 A.2d 1040, 1048–49 (Del. 2004); *see also Weiss v. Swanson*, 948 A.2d 433, 441 (Del. Ch. 2008) (“The requirement of particularized facts means a plaintiff’s pleading burden in the demand [futility] context is more onerous than that required to withstand a Rule 12(b)(6) motion.” (citation and internal quotation marks omitted)).

B. Federal Rule of Civil Procedure 12(b)(6)

Under Federal Rule of Civil Procedure 12(b)(6), a complaint may be dismissed for failure to state a claim upon which relief may be granted. Dismissal may be based on “the lack of a cognizable legal theory or the absence of sufficient facts alleged under a cognizable legal theory.” *Balistreri v. Pacifica Police Dep’t*, 901 F.2d 696, 699 (9th Cir. 1990). For purposes of evaluating a motion to dismiss, a court “must presume all factual allegations of the complaint to be true and draw all reasonable inferences in favor of the nonmoving party.” *Usher v. City of Los Angeles*, 828 F.2d 556, 561 (9th Cir. 1987). A complaint must plead “enough facts to state a claim to relief that is plausible on its face.” *Ashcroft v. Iqbal*, 556 U.S. 662, 697 (2009) (*citing Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). A claim is plausible “when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” *Id.* “Courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.” *Tellabs v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322 (2007).

III. DISCUSSION

Defendants argue that Birmingham fails to plead demand futility under Federal Rule of Civil Procedure 23.1 and to plausibly state a claim under Federal Rule of Civil Procedure 12(b)(6). The Court discusses each argument in turn.

A. Demand Futility

1. Legal Standard

A shareholder seeking to vindicate the interests of a corporation through a derivative suit must first demand action from the corporation's directors or plead with particularity the reasons why such demand would have been futile." *Rosenbloom*, 765 F.3d at 1147 (quoting *In re Silicon Graphics*, 183 F.3d 970, 989 (9th Cir. 1999)); *see* Fed. R. Civ. P. 23.1. Birmingham did not make a demand on the Netflix Board. Instead, it alleges that such a demand would have been futile because a majority of the Board faces a substantial likelihood of liability for violating federal securities laws and tax laws.[5] *Id.* ¶¶ 111–16. Because "[t]he substantive law which determines whether demand is, in fact, futile is provided by the state of incorporation of the entity on whose behalf the plaintiff is seeking relief," Delaware law applies here. *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 138 (2d Cir. 2004) (cited with approval in *Rosenbloom*, 765 F.3d at 1148).

The Delaware Supreme Court has articulated two tests for determining whether a complaint sufficiently pleads demand futility: the *Aronson* test and the *Rales* test. *See Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). Delaware courts apply the *Aronson* test if the derivative action challenges a particular decision or transaction of the corporation's board of directors. *See Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008). Under *Aronson*, the plaintiff must plead particularized facts that create a reasonable doubt that either (1) the directors were disinterested or independent, or (2) the challenged transaction was the product of a valid exercise of business judgment. *See* 473 A.2d at 812.

On the other hand, Delaware courts apply *Rales* if the subject of the derivative suit is not a business decision of the board but rather a violation of the board's oversight duties. *See Wood*, 953 A.2d at 140; *see also Guttman v. Huang*, 823 A.2d 492, 499–500 (Del. 2003) (applying *Rales* where the plaintiffs alleged that director defendants individually breached their fiduciary duties to the corporation and failed "to ensure that [the corporation] had in place the financial control

[5] Birmingham does not argue that a majority of the Board lacked independence or were otherwise interested in the Plan. *See generally* Opp.

systems necessary to ensure compliance with applicable accounting standards"). The *Rales* test simply requires the plaintiff to offer particularized allegations to create a reasonable doubt as to the first prong of the *Aronson* test:

> Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.

Rales, 634 A.2d at 934; *see also In re Bidz.com, Inc. Derivative Litig.*, 773 F. Supp. 2d 844, 855 (C.D. Cal. 2011).

The Ninth Circuit has held that the difference between the *Aronson* and *Rales* tests is blurred in cases where a derivative claim alleges wrongdoing by a majority of the board but does not challenge a specific board decision. *Rosenbloom*, 765 F.3d at 1150 (collecting cases). For such hybrid claims, courts excuse demand if "Plaintiffs' particularized allegations create a reasonable doubt as to whether a majority of the board . . . faces a substantial likelihood of personal liability." *Id.* Both parties agree this standard applies. *See* Mot. at 9–10; Opp. at 20. Netflix's certificate of incorporation exculpates members of its Board from personal liability.[6] *See* Strickland Decl. ISO Opp., Ex. A, art. VIII, ECF 31-1. As such, Birmingham can establish the substantial likelihood of liability necessary to excuse demand only by pleading "bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties." *In re Gen. Motors Co. Derivative Litig.*, C.A. No. 9627, 2015 WL 3958724, at *12 (Del. Ch. June 26, 2015) (emphasis in original) (citation omitted), *aff'd,* 133 A.3d 971 (Del. 2016) (TABLE); *see also In re Yahoo! Inc. S'holder Derivative Litig.*, 153 F. Supp. 3d 1107, 1120 (N.D. Cal. 2015) (finding pre-suit demand not excused because plaintiffs failed to establish that the directors acted in "bad faith"). An allegation that a defendant should have known of misconduct does not constitute

---

[6] Defendants request the Court take judicial notice of this document. Birmingham does not object. Because judicial notice of publicly filed SEC documents is proper, the Court takes judicial notice of this document. *See Northstar Fin. Advisors Inc. v. Schwab Investments*, 779 F.3d 1036, 1043 (9th Cir. 2015), *as amended on denial of reh'g and reh'g en banc* (Apr. 28, 2015).

particularized facts of actual knowledge. *See In re CNET Networks, Inc.*, 483 F. Supp. 2d 947, 964 (N.D. Cal. 2007).

Demand futility can be established without "a smoking gun of Board knowledge," by "alleging particular facts that support an inference of conscious inaction." *Rosenbloom*, 765 F.3d at 1156 (citation and emphasis omitted). However, it is "a rare case where the circumstances are so egregious that there is a substantial likelihood of liability." *In re Baxter Int'l, Inc. S'holder Litig.*, 654 A.2d 1268, 1271 (Del. Ch. 1995) (citing *Aronson*, 473 A.2d at 815).

2. Defendants' Demand Futility Arguments

In this case, Birmingham's main argument is that demand is excused because a majority of the Board faces a substantial likelihood of liability for authorizing the issuance of proxies that they knew to be false or misleading. *See* Opp. 10–25. Defendants argue that Birmingham has not sufficiently pled particularized facts demonstrating that a majority of the Board intentionally caused Netflix to violate the law. *See, e.g.*, Mot. at 12.

Specifically, Defendants argue that Birmingham must allege each of the following steps to establish that a majority of the Board faces a substantial likelihood of liability for violating Section 14(a)[7]: (1) the bonus targets violated Section 162(m) because they were not substantially uncertain; (2) a majority of directors knew of and understood the requirements of Section 162(m); (3) a majority of directors knew that the bonus targets violated Section 162(m); (4) the proxies were false or misleading; (5) a majority of directors knew that the proxies were false or misleading; and (6) a majority of directors was responsible for issuing the proxies. *Id.* at 12–18. Defendants argue that Birmingham does not allege any of these steps. And they argue that

---

[7] The Court notes that Birmingham does not allege facts demonstrating that Defendants violated the tax laws, though the Complaint says so in a conclusory fashion. *See, e.g.*, Compl. ¶ 126; *cf.* Opp. at 21–25 (not including knowing violation of tax laws in breach of fiduciary duty arguments). There are no allegations that Defendants actually took a tax deduction on the bonuses given to the executives. Even if the Plan did not comply with Section 162(m), it would simply mean that Netflix could not deduct the bonuses. But Birmingham does not allege that the inability to deduct bonuses is, in and of itself, a tax law violation.

Instead, Birmingham alleges that Defendants knew the bonuses would not be tax deductible under Section 162(m), but told Netflix's shareholders that the bonuses could and were intended to be tax deductible. The alleged illegal act (and the alleged breach of fiduciary duty), then, was the issuance of a proxy that they knew to be false or misleading.

Birmingham has not pled demand futility for its waste claim. The Court discusses each argument in turn.

a. Section 14(a) and Fiduciary Duty Claims

i. Whether the Bonus Targets Did Not Comply With Section 162(m) Because They Were Not Substantially Uncertain

Defendants first argue that there is no underlying violation of Section 162(m) for which a majority of the Board could be substantially liable. At bottom, Defendant rejects Birmingham's "theory that if a company (allegedly) has reason to believe it may reach a certain performance target, bonuses awarded based on the achievement of that target are not performance-based and, thus, not deductible for purposes of Section 162(m)." Mot. at 13. Defendants contend that even a company that "'confidently and consistently predict[s]' that it will meet its goals" can still be substantially uncertain that such goals will be met. *Id.* (quoting *Seinfeld v. O'Connor*, 774 F. Supp. 2d 660, 672 (D. Del. 2011)). Likewise, a history of profitability does not, in itself, render a target sufficiently certain. *Id.* (citing 26 C.F.R. § 1.162-27(e)(2)(vii)(Example 3)).

The Court disagrees. The relevant treasury regulations include examples of targets that would and would not be "substantially uncertain" under Section 162(m). Example 4 is closely aligned with the allegations here:

> B is the general counsel of Corporation R, which is engaged in patent litigation with Corporation S. Representatives of Corporation S have informally indicated to Corporation R a willingness to settle the litigation for $50,000,000. Subsequently, the compensation committee of Corporation R agrees to pay B a bonus if B obtains a formal settlement for at least $50,000,000. The bonus to B does not meet the requirement of this paragraph (e)(2) because the performance goal was not established at a time when the outcome was substantially uncertain.

26 C.F.R. § 1.162-27(e)(2)(vii)(Example 4). In this example, Corporation R learns that Corporation S wants to settle for $50,000,000, and then the compensation committee sets a performance target of a $50,000,000 settlement, making the target not substantially uncertain.

This scenario is similar to what Birmingham alleges happened here: The Compensation Committee learned that Netflix was projected to achieve a certain result and then set performance targets to mirror those projections. Each quarter, before the Committee set the performance targets, the Board received quarterly projections for Netflix's global streaming revenue. Compl.

¶¶ 83, 86, 88, 91, 94, 97, 99, 102, 104, 107. These projections were highly accurate because they were measured over a single quarter and because Netflix's business model made them predictable. *Id.* ¶ 6. With these projections in hand, and with a working knowledge of Section 162(m), the Committee set global streaming revenue targets that substantially mirrored the projections. *Compare, e.g.*, Compl. ¶ 83 (projection of [redacted]) *with id.* ¶ 82 (target of $1,474,000,000); *id.* ¶ 86 (projection of [redacted]) *with id.* ¶ 85 (target of $1,593,000,000); *id.* ¶ 91 (projection of [redacted]) *with id.* ¶ 90 (target of $1,813,000,000). Moreover, the Company needed to achieve only 80% of these targets in order to allocate a portion of the bonuses. *Id.* ¶ 61. Given the identity between the projections and the targets, in addition to the 80% limitation, Birmingham has sufficiently alleged that there is a substantial likelihood that the targets were not substantially uncertain under Section 162(m).

The alleged facts here are more damning than in *Seinfeld*, relied upon by Defendants, where the court held a performance-payment plan complied with Section 162(m). There, the targets were based on cost-reductions achieved in a merger with another company, a more unpredictable venture than the business practices alleged here. 774 F. Supp. 2d at 662, 672. Moreover, the time horizon was longer than a single quarter and the company received projections almost 33% lower than the targets it ultimately set. *Id.* Also, contrary to Defendants' arguments, this is not a case in which the Court has trouble discerning which positive law is allegedly violated—Birmingham alleges the Board violated the law by falsely telling shareholders that the Plan complied with Section 162(m) and its attendant regulations. *Cf. Wilkin v. Narachi*, No. CV 12412-VCMR, 2018 WL 1100372, at *11 (Del. Ch. Feb. 28, 2018). That the Internal Revenue Service has not brought an enforcement action or started an investigation of Netflix is in no way controlling. Had the IRS instituted such an action or an investigation, that would certainly be instructive that the Plan might have substantial issues under Section 162(m), but the inverse is not true—a failure to investigate could be attributable to numerous factors unrelated to the Plan's compliance with Section 162(m).

ii. Whether a Majority of Directors Knew About Section 162(m)'s Requirements

Defendants next argue that Birmingham does not plausibly allege "that *any* director at *any* point knew or was advised that the bonuses might not be deductible under Section 162(m)." Mot. at 15. This argument seemingly equates to the claim that the Complaint does not allege that any of the directors knew about Section 162(m).

To the extent this is Defendants' argument, it fails. Birmingham alleges that on March 18, 2015, the Compensation Committee reviewed Section 162(m) and decided it was time to implement the Plan. Compl. ¶¶ 46, 60. That same day, the "*full Board* met and received a report from Defendant Haley that provided the [Compensation] Committee's discussion of [] the performance bonus plan and tax implications under 162(m) of the IRS Code." *Id.* ¶ 46 (emphasis added). This allegation sufficiently demonstrates that each member of the Board (*i.e.*, "the full Board") was aware of and had been briefed on Section 162(m) and the Plan's proposed compliance with it. Though the Complaint does not allege exactly what Defendant Haley told the Board about Section 162(m), as discussed more below, the Court can infer that the Board was at least aware of Section 162(m)'s general contours and how the Plan was meant to comply with it.

iii. Whether a Majority of Directors Knew the Bonus Targets Did Not Comply With Section 162(m) Because They Were Not Substantially Uncertain

Most substantially, Defendants argue that even if Defendants were allegedly aware of Section 162(m)'s requirements, "that is not equivalent to *knowingly violating* the regulation." Mot. at 15. They argue that because the alleged knowledge of the Compensation Committee cannot be imputed to other directors, the Complaint must contain allegations specific to each director's knowing violation.

As an initial matter, the Court notes that plaintiffs in securities actions are not always required to allege facts as to each individual director. The question instead is "whether a majority of the board . . . faces a substantial likelihood of personal liability." *Rosenbloom*, 765 F.3d at 1150. The court in *Rosenbloom* explicitly recognized that "[w]hen appropriate, courts may evaluate demand futility by looking to the whole board of directors rather than by going one by one through its ranks." *Id.* at 1150 n.13. In *Rosenbloom*, because the "Plaintiffs [had] repeatedly allege[d] that a majority of the Board was involved in all (or nearly all) of the programs and

decisions at issue" for a substantial period of time, the non-individualized allegations were sufficient.[8] *Id.*; *id.* at 1150–56. At the same time, the complaint in *Rosenbloom* alleged that the actions by the majority of the Board were substantial and pervasive, indicating that individualized allegations will be necessary unless there are substantial allegations from which the Court can infer that a majority of the Board was involved. *See Durgin v. Sharer*, No. 07-CV-3001-PSG, 2017 WL 2214618, at *10 (C.D. Cal. Jan. 10, 2017) (rejecting plaintiff's argument that they need not allege violations on director-by-director basis because the Complaint did not "provide particularized factual allegations concerning the majority of the Board" comparable to the substantial allegations in *Rosenbloom*); *Shaev v. Baker*, No. 16-CV-05541-JST, 2017 WL 1735573, at *10 n.8 (N.D. Cal. May 4, 2017) (not requiring director-by-director allegations where allegations pertained to actions of the whole board or of a specific committee).

At issue here is whether a majority of the Board allegedly knew that the bonuses did not comply with Section 162(m). Because Netflix has an exculpatory charter provision, Plaintiff must "plead particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their conduct was legally improper." *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009). For a disclosure claim, Plaintiff must plead particularized factual allegations that "support the inference that the disclosure violation was made in bad faith, knowingly or intentionally." *Id.* at 132 (quoting *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 915 (Del.Ch. Aug. 20, 1999)). To show that a director acted knowingly in issuing a misleading disclosure, Plaintiff must plead, in part, "what the directors knew and when," as well as "factual allegations regarding the knowledge or bad faith of the individual director defendant," as opposed to "broad group allegations." *Id.* at 133–34. Ultimately, the Court must analyze "the state of mind of individual director defendants" to determine what they knew about the allegedly misleading statement. *Id.* at 134.

Given this need for detailed factual allegations to support any inference of knowledge, in

---

[8] The Court notes that this standard differs from the standard on a 12(b)(6) motion, where the culpability of *each* Defendant must be specifically alleged. *See In re Verisign, Inc., Derivative Litig.*, 531 F. Supp. 2d 1173, 1213 (N.D. Cal. 2007).

order for Plaintiff to sufficiently allege that a majority of the Board knew that the chosen bonuses did not comply with Section 162(m), Plaintiff would have to allege that a majority of the Board knew (1) what Section 162(m) specifically requires for performance-based bonuses to comply; (2) that each performance target set by the Compensation Committee was substantially identical to the performance projections received by the Board; (3) that the Company was continually achieving the chosen targets with exactitude; and (4) that the identity between the projections and the targets indicated that the Plan did not comply with the requirements of Section 162(m).

As to the Compensation Committee, the Complaint adequately alleges that the Committee directors knew each of these key pieces of information. The Committee reviewed the IRS regulations for Section 162(m). Compl. ¶ 46. They then changed the 2015 Proxy CD&A to implement the Plan. *Id.* Every quarter for two years after this, the Committee set quarterly performance targets that mirrored the projections the Board received each quarter. *See, e.g.*, *id.* ¶¶ 82, 83, 85, 86, 87, 88, 90, 91. They then certified the bonus awards each quarter because the Company had achieved the targets. *See, e.g.*, *id.* ¶¶ 84, 87, 89. The Committee thus knew that the Company had achieved the chosen targets with near exactitude each quarter. From these facts, it is reasonable to infer that at least the Compensation Committee knew that the Plan did not comply with Section 162(m). But because the Committee's knowledge cannot be imputed to the other Director Defendants, the Court must analyze the allegations as to those Defendants independently. *See Towers v. Iger*, 912 F.3d 523, 530 (9th Cir. 2018).

By contrast, as to the remainder of the Board, the Court finds that the Complaint is missing specific factual allegations necessary to support the conclusion that a majority of the Board knew of the non-compliance.

First, Birmingham has not alleged that any individual director, or even a non-specific majority of the Board, had a working knowledge of Section 162(m). Although Defendant Haley gave the Board a report discussing "the performance bonus plan and tax implication of Section 162(m)," Compl. ¶ 46, there are no details alleged as to what the report told the Board about Section 162(m), and thus what any Board member knew about how bonuses could be "substantially uncertain."

Second, Birmingham does not allege that a majority of the Board knew the chosen targets for any given year. The only alleged means by which the Board was apprised of the targets was in the proxies themselves; the 2016 proxy listed the 2015 quarterly targets and outcomes and the 2017 proxy listed the 2016 quarterly targets and outcomes. *Id.* ¶¶ 70–71, 76–77. But Birmingham does not allege that any individual director or that a majority of the Board ever reviewed the proxies. Though Birmingham alleges that the Compensation Committee was tasked with "recommend[ing] to the Board that the [CD&A] be included in the proxy Statement and incorporated into the Company's Annual Report," *id.* ¶ 48, it only alleges that such a meeting was held before the 2015 proxy was issued, not before the 2016 or 2017 proxies were issued. Likewise, Birmingham alleges that "the Board" "order[ed]" or "authorized the filing of" the 2016 and 2017 proxies, *id.* ¶¶ 42, 46, 62, 67, 73, and that "all of the directors on the Board caused Netflix to issue" the 2016 and 2017 proxies, *id.* ¶¶ 67, 73. But these allegations are not sufficient to allege which Board members (or how many) were actually involved in reviewing and/or issuing the proxies. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 134 (Del. Ch. 2009) (finding allegations insufficient where plaintiff had not sufficiently alleged directors' involvement in preparation of the documents). Plaintiff does not include any allegations as to the process by which proxies are issued by the Company (for example, whether a majority vote of the Board is required to issue any proxy). Based on these allegations, the Court cannot infer which directors (or how many) saw the proxies, and in turn the quarterly targets. This is not a case like *Rosenbloom*, where the allegations of Board action (or inaction) are so substantial as to allow the Court to simply infer a majority, without more detailed allegations.

Third, even if Plaintiff had alleged that a majority of the Board had reviewed the proxies, the Court still might not infer from the current allegations that a majority of the Board knew those targets did not comply with Section 162(m). The Board was informed about Section 162(m) in March 2015, but the proxies were not issued until April 2016 and April 2017. *Id.* ¶¶ 67, 73. Without more information about what the Board knew about Section 162(m), the Court cannot infer that a year or two later, a majority of the Board had a working knowledge of the requirements of Section 162(m) that would allow them to discern that the parity between the

targets, the projections, and the outcomes indicated a non-compliance with Section 162(m). This is especially true given that the Committee chose to increase the targets each quarter, such that the target in the third quarter of 2017 more than doubled the target chosen in the first quarter of 2015. *Id.* ¶¶ 81, 106.

Ultimately, Birmingham has not alleged sufficient facts about "what the directors knew and when," or about "the state of mind of individual director defendants" to determine whether a majority of the Board knew the bonuses did not comply with Section 162(m). *In re Citigroup Inc.*, 964 A.2d at 133–34.

iv. Whether the proxies Were False or Misleading

Defendants next argue that the proxies were not materially false or misleading, such that a majority of the Board cannot face liability for violations of Section 14(a) of the Securities Exchange Act of 1934. "Section 14(a) seeks to prevent management or others from obtaining authorization for corporate actions by means of deceptive or inadequate disclosures in proxy solicitations." *Shaev v. Saper*, 320 F.3d 373, 379 (3d Cir. 2003). "Information is deemed material for purposes of a § 14(a) claim 'if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.'" *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1331 (3rd Cir. 2002) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

Defendants argue that even if the Plan did not comply with Section 162(m), the proxies were not misleading or false because they said only that the Plan was *intended* to comply with Section 162(m), not that it was *guaranteed* to comply with Section 162(m). *See* Compl. ¶ 64 (2015 proxy said Plan was created "[i]n order to comply with [Section] 162(m)"); *id.* ¶¶ 69, 71 (2016 proxy said Plan "[wa]s intended to permit the Company to seek a full federal tax deduction for compensation paid under the Plan" and that Plan bonuses were "performance-based"); *id.* ¶¶ 75, 77 (same for 2017 proxy). Thus, they argue that even if the Plan does not comply with Section 162(m), the proxy is not misleading because the proxy merely stated an opinion that turned out to be incorrect. In support of this argument, Defendants rely on cases that hold that statements of opinion or intent are not actionable simply because they turned out to be wrong. *See* Mot. at 16–17.

Defendants' obvious error in reasoning is that this case is not one in which the creators of the Plan—the Compensation Committee—allegedly "got it wrong." As discussed above, Birmingham has alleged that the Compensation Committee knowingly set the Plan's bonus targets to mirror the projections they had previously received. It follows directly then that the Plan was not "intended" to comply with Section 162(m) and thus that the proxies were misleading. The alleged facts here are similar to those in *Shaev v. Saper*. There, the proxy "explained that the Board intended to administer the amendment in a way that would allow the Company to deduct bonuses and incentive payments for tax purposes" and that "shareholder approval . . . [was] required . . . for bonuses payable under [the performance plan] . . . to be deductible under 162(m)." *Shaev v. Saper*, 320 F.3d 373, 376 (3d Cir. 2003). The Third Circuit held this language was materially misleading because the Board knew that the Plan could not and did not comply with Section 162(m). *Id.* at 380–81. Likewise, in *Resnik v. Woertz*, the proxy statements stated that the plan was "designed to be performance-based and comply with 162(m)," when in fact it was unable to comply with Section 162(m), so the court held the statements were materially misleading. 774 F. Supp. 2d 614, 631 (D. Del. 2011).

Just as in those cases, it is adequately alleged that the "intended to comply" language here was materially misleading because the Compensation Committee did not believe that the Plan was intended to comply with Section 162(m). *Cf. In re Bank of Am. Corp. Sec., Derivative, & Employee Ret. Income Sec. Act (ERISA) Litig.*, 757 F. Supp. 2d 260, 299–300 (S.D.N.Y. 2010) ("Failure to disclose a 'prospective' or 'contingent' material fact may run afoul of Rule 14a–9 if 'there appears to be a reasonable likelihood' that it will occur." (quoting *Wilson v. Great Am. Inds., Inc.*, 855 F.2d 987, 992 (2d Cir. 1988)). Put another way, even if the language can be read to assert a mere belief that the Plan would comply with Section 162(m), the statements were still misleading because the Compensation Committee did not actually believe the Plan would comply and did not share that relevant information with the shareholders. *See Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1328 (2015) ("[A]n issuer's statement of opinion may fairly imply facts about the inquiry the issuer conducted or the knowledge it had. And if the real facts are otherwise, but not provided, the opinion statement will mislead by

omission.")

Defendants' attempts to distinguish these cases are ultimately unavailing. Contrary to their arguments, *Shaev* is on point because there, like here, the plaintiff had alleged that the board (here, the Committee) "[was] intentionally manipulating" the performance plan. Reply at 10. Although the plan at issue in *Shaev* could not actually have complied with Section 162(m), while the Plan here was only highly likely not to comply with Section 162(m), the Court can similarly infer from the allegations here that the Committee never *intended* for the Plan to comply with Section 162(m). For the same reason, the cases Defendants cite are not persuasive because those cases did not include allegations that any directors *knew* that the performance plans did not comply with Section 162(m). *See In re Caterpillar Inc. Derivative Litig.*, No. CV 12-1076-LPS-CJB, 2014 WL 2587479, at *14 (D. Del. June 10, 2014); *Seinfeld v. O'Connor*, 774 F. Supp. 2d 660, 667–68 (D. Del. 2011); *see also Seinfeld*, 774 F. Supp. 2d at 667 (distinguishing *Shaev*, in part, because the *Shaev* directors "had already effectively decided to pay bonuses no matter the outcome of the shareholder vote").

Likewise, the fact that the proxies in *Shaev* and *Resnik* did not elucidate the performance goals was an independent, not a necessary, reason for finding the proxies misleading. *Shaev*, 320 F.3d at 382; *Resnik*, 774 F. Supp. 2d at 632. And again, the fact that the plans in *Shaev* and *Resnik* could not have possibly complied with Section 162(m) is of no moment because the Court here finds that Plaintiff has adequately alleged that the Plan does not comply with Section 162(m). If the Plan had complied with Section 162(m), then Defendants would seemingly be correct, as the Supreme Court in *Virginia Bankshares, Inc. v. Sandberg* held that when a director issues a statement believing it to be false, but the statement is actually true, the director is not liable under Section 14(a). 501 U.S. 1083, 1095– 96(1991). But that is not what allegedly happened. Here, the allegations state that the Plan did not comply with Section 162(m), and indeed was not intended to, making this case at the pleading stage more closely analogous to *Omnicare*, 135 S. Ct. at 1328, where the Supreme Court held that expressions of opinion may be false or misleading if they omit important information about "how the speaker has formed the opinion." *See id.* at 1326 n.2, 1329 n.7 (distinguishing *Virginia Bankshares*).

Ultimately, the Court holds that the Complaint sufficiently alleges that the proxies were misleading.

v. Whether a Majority of Directors Knew the Proxies Were False or Misleading

Defendants argue that even if the proxies were misleading, Birmingham does not allege that a majority of the Board knew the proxies were misleading or false. *See* Mot. at 17. The Court agrees for the same reasons the Court determined that Birmingham has not alleged that a majority of the Board knew that the Plan did not comply with Section 162(m). Because Birmingham has not alleged that a majority of the Board was sufficiently familiar with Section 162(m) or authorized the proxies, the Court cannot say that a majority of the Board knew that the proxies misleadingly stated that the Plan was intended to comply with Section 162(m).

vi. Whether a Majority of Directors Knowingly Issued the Allegedly Misleading Proxies

Likewise, the Court has already determined that Birmingham has not sufficiently alleged that a majority of the Board was involved in issuing the proxies, for instance by alleging that a majority of the Board voted yes to issuing the proxy or that a majority vote of the Board was necessary for any such proxy to issue. Of course, there may be meaningful differences between the issuance of proxy statements that on their faces can identify the allegedly misleading statement and the issuance of mere financial documents, as occurred in many of the cases Defendants cite. *See In re Citigroup*, 964 A.2d at 133 & n.88, 134; *Guttman*, 823 A.2d at 498. But the Complaint does not include any allegations allowing the Court to draw such a distinction. As such, the Court holds that Birmingham has failed to allege that a majority of the Board knew the proxies were allegedly misleading.

b. Waste Claim

"Delaware law provides stringent requirements for a plaintiff to state a claim for corporate waste," and the "test to show corporate waste is difficult for any plaintiff to meet." *In re Citigroup*, 964 A.2d at 136. Corporate waste "entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000). "As a

practical matter, a stockholder plaintiff must generally show that the board irrationally squandered corporate assets—for example, where the challenged transaction served no corporate purpose or where the corporation received no consideration at all." *White v. Panic*, 783 A.2d 543, 554 (Del. S. Ct. 2001) (internal quotation and alteration omitted).

Even though Birmingham successfully alleges that the Plan was not deductible under Section 162(m), these allegations are not sufficient to allege a claim of corporate waste. That the Compensation Committee knew the Company would achieve the performance targets does not mean that the compensation paid to the top executives was wholly "unwarranted." Opp. at 19 n.7. Birmingham does not allege that the executives performed no work (*i.e.* gave *de minimis* consideration) such that paying them beyond their normal salaries was a violation of the deferential business judgment rule. *See Oswald v. Identiv, Inc.*, No. 16-CV-00241-CRB, 2017 WL 4877423, at *11 (N.D. Cal. Oct. 27, 2017) (paying executive who had defrauded the company was not waste because the executive had provided more than "zero value" to the Company and the Court could not say the payment was "in exchange for nothing.").

As such the Complaint fails to allege demand futility for the waste claim.

* * *

Because Birmingham fails to allege that a majority of the Board faces a substantial likelihood of liability for any its claims, the Court holds that Birmingham fails to allege demand futility as required under Rule 23.1.

B. Failure to State a Claim

Though the Court need not reach Defendants' arguments that Birmingham fails to state a claim against Defendants, the Court addresses these arguments because Birmingham's claims fall short on several fronts that may impact any amendments.

1. Violation of Section 14(a)

To state a claim under § 14(a), a plaintiff must show that (1) the defendant made a material misrepresentation or omission in a proxy statement, (2) the misrepresentation or omission was made with the requisite level of culpability, and (3) the misrepresentation or omission was an essential link in the accomplishment of a transaction proposed in the proxy solicitation. *See*

Desaigoudar v. Meyercord, 223 F.3d 1020, 1022 (9th Cir. 2000). In addition, a plaintiff must establish that the allegedly misleading proxy caused the plaintiff injury in the form of economic loss. *New York City Employees' Ret. Sys. v. Jobs*, 593 F.3d 1018, 1022 (9th Cir. 2010), *overruled on the other grounds by Lacey v. Maricopa Cty.*, 693 F.3d 896 (9th Cir. 2012). Private plaintiffs asserting claims under the securities laws must also meet the heightened pleading standards of the Private Securities Litigation Reform Act ("PSLRA"). *Id.* Under the PSLRA, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *See In re Zoran Corp. Derivative Litig.*, 511 F. Supp. 2d 986, 1010 (N.D. Cal. 2007) (quoting 15 U.S.C. 78u–4(b)(2)). When the allegations sound in fraud, the plaintiff must allege specific facts demonstrating that the defendant acted knowingly and deliberately. *See* Fed. R. Civ. Proc. 9(b); *Kearns v. Ford Motor Co.*, 567 F.3d 1120, 1124 (9th Cir. 2009) ("Where fraud is not an essential element of a claim, only those allegations of a complaint which aver fraud are subject to Rule 9(b)'s heightened pleading standard."). Otherwise, allegations of negligence suffice. *In re Asyst Techs., Inc. Derivative Litig.*, No. C-06-04669 EDL, 2008 WL 2169021, at *8 (N.D. Cal. May 23, 2008)

The Court has already determined that Birmingham has alleged that the proxies contained material misrepresentations or omissions. The Court discusses whether the Complaint alleges Defendants issued the proxies with the requisite culpability and the essential link and injury requirements in turn.

a. Whether Defendants issued the statements with the requisite state of mind

i. Officer Defendants

Put simply, there are no allegations that would raise an inference that the Officer Defendants—as mere recipients of the bonuses at issue (Hunt, Sarandos, Peters, Hyman) or as CFO of the company (Wells)—are somehow liable for violating Section 14(a). There are no allegations that these Defendants knew about the projections in advance or had any involvement whatsoever in the issuing of the proxies. Indeed, Birmingham does not even address these Defendants in its Opposition. As such, the claim is dismissed against the Officer Defendants with

leave to amend.

ii. Director Defendants

To demonstrate that any director Defendant made a material misrepresentation or omission in the proxies with the requisite level of culpability (either negligence or fraud), Birmingham would have to allege that each director Defendant (1) made the statement and (2) acted with the required state of mind—here, knowingly or negligently. *See In re Maxim Integrated Prod., Inc., Deriv. Lit.*, 574 F. Supp. 2d 1046, 1066 (N.D. Cal. 2008) (holding individual defendants liable where it was alleged that each one issued the proxy statements); *In re Verisign*, 531 F. Supp. 2d at 1213 (dismissing the claim because the plaintiffs "fail[ed] to plead the required state of mind with particularity as to each defendant").

Here, the only allegations Birmingham includes as to specific individual directors' states of mind are allegations that state that the Compensation Committee members created and executed the Plan in bad faith, knowing it would not comply with Section 162(m), and then recommended the Plan and the CD&A's for each proxy to the Board with that knowledge. But Birmingham makes no specific allegations as to the other Director Defendants' states of mind. And Birmingham does not allege which Director Defendants were ultimately involved in the issuing of the proxies. Though "the Board" is alleged to have authorized the issuing, this tells the Court and the Defendants nothing about which members of the Board made the allegedly misleading disclosures. Thus, the allegations do not plead with particularity that any individual defendant made a misleading statement with the requisite level of culpability.

Birmingham argues that its allegations are sufficient because "directors' duties alone are sufficient to support a pleading-stage inference of negligence in a Section 14(a) case." Opp. at 16 (citing cases). This argument first assumes that the required state of mind here is mere negligence. However, the Complaint appears to allege a "rigged" ploy to mislead investors, *see* Compl. ¶¶ 8, 40, a scheme which sounds in fraud and would require allegations of bad faith, not mere negligence under the PSLRA. But even assuming negligence is all that is required, Birmingham has not sufficiently alleged individual directors' duties that would allow the Court to infer negligence (except as to the Compensation Committee). Birmingham only alleges specific duties

United States District Court
Northern District of California

of the Compensation and Audit Committees. *See generally* Complaint. To show that these members acted negligently, Birmingham would need to allege that they were involved in the issuance of the disclosures. *See In re Maxim*, 574 F. Supp. 2d at 1066 (holding directors were at least negligent because they "issued" misleading proxies); *In re Fossil, Inc.*, 713 F. Supp. 2d 644, 655 (N.D. Tex. 2010) (holding directors were at least negligent because they "signed and approved [false] proxies"). And in any event, though Birmingham alleges the Audit Committee was responsible for reviewing and confirming the accuracy of "financial statements," Compl. ¶ 49, Birmingham does not allege that these duties apply to the proxy statements with respect to the Plan. It is not immediately obvious that these alleged duties would cover review and confirmation of the Plan's compliance with Section 162(m), as was the case in similar cases holding that alleged duties can be sufficient for finding negligence. *See, e.g.*, *In re Zoran*, 511 F. Supp. 2d at 1015–16 (holding plaintiffs sufficiently satisfied this element where complaint alleged that defendants had duties to oversee the actions that were at issue); *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1062–63 (C.D. Cal. 2008) (same).

As such, Birmingham has failed to allege that any Director Defendant issued the allegedly misleading proxies with the requisite intent.

b. Essential Link and Economic Injury

Under § 14(a), a plaintiff must demonstrate that the allegedly misleading proxies caused it both to engage in the transaction in question (*i.e.*, transaction causation or the essential link requirement) and to suffer economic harm (*i.e.*, loss causation). *See Grace v. Rosenstock*, 228 F.3d 40, 46 (2d Cir. 2000). Transaction causation, as is relevant here, requires the plaintiff to allege that the allegedly misleading statement caused the shareholder to vote to approve the action. Loss causation requires a showing that the defendant "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u–4(b)(4). To show loss causation, a plaintiff must prove both economic loss and proximate causation. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346 (2005). In well-pled § 14(a) claims, loss causation connects the proxy misstatements with an actual economic harm. *Jobs*, 593 F.3d at 1023.

Birmingham has successfully alleged transaction causation but fails to allege loss

causation. As to the former, Birmingham alleges that the proxies informed the shareholders that the Plan was designed to take advantage of the tax deductions available under Section 162(m). *See* Compl. ¶¶ 64, 69, 71, 75, 77. Had the shareholders known that the Plan was not intended to comply with Section 162(m), it is fair to say they might not have approved it because the compensation to be awarded under the Plan was substantial and could be viewed by a reasonable shareholder as excessive, absent a tax deduction. *Id.* ¶¶ 111, 127. The shareholder might then have determined that the Plan should not be adopted. *See In re Wells Fargo & Co. S'holder Derivative Litig.*, 282 F. Supp. 3d 1074, 1103 (N.D. Cal. 2017) (holding § 14(a) claim was actionable because members of the Board "failed to disclose[] a fraudulent business practice that put the company at material risk," which if disclosed would have caused shareholders to vote differently).

By contrast, Birmingham has not sufficiently alleged loss causation. The only injury to Netflix that Birmingham alleges is the "paying of excessive fees to certain executive officers," damages to "its corporate image and goodwill," and the "possibility that Netflix will sustain additional monetary and reputational damages should the IRS undertake an investigation into the misconduct alleged herein." Compl. ¶ 127. As to damages to corporate image and goodwill, these harms are not sufficiently pled and also not allegedly caused by the proxy statements themselves, as opposed to the allegedly fraudulent tax scheme. As to the potential liability for a tax investigation, such injuries are entirely speculative, especially in light of the fact that Birmingham has not actually alleged a violation of tax laws. Finally, as to the paying of excessive fees, executive compensation is within the purview of the Board's business judgment. *See Oswald*, 2017 WL 4877423, at *11. Without more, the Court cannot infer that these substantial bonuses constitute injury to Netflix. *Cf. In re Wells Fargo*, 282 F. Supp. 3d at 1104 (allegations that excessive compensation was paid to directors responsible for implementing fraudulent scheme were sufficient). Indeed, Birmingham does not argue in its Opposition that any allegedly excessive payments caused an injury (and cites no cases to support such an argument), focusing instead on the reelection of certain directors based on the misleading proxies. *See* Opp. at 17–18.

Had Birmingham plausibly alleged that the Plan as implemented (and authorized by the

shareholders due to the proxies) caused Netflix injury, then the reelection of any directors knowingly implementing the Plan fraudulently could suffice to allege loss causation, because those directors arguably were then able to continue implementing the injurious plan. *See In re Wells Fargo*, 282 F. Supp. 3d at 1105; *In re Fossil*, 713 F. Supp. 2d at 655. But because Birmingham does not allege any injury to Netflix (or that any director other than the Compensation Committee acted knowingly), Birmingham fails to plead loss causation and thus a violation of Section 14(a).

2. Breach of Fiduciary Duties

Birmingham's fiduciary duty claim is premised on its claim for a violation of § 14(a). Because the § 14(a) claim is not sufficiently alleged, Birmingham's fiduciary duty claim fails as well. Moreover, Birmingham has failed to allege a claim of bad faith, as required by the exculpatory charter, against any of the Director Defendants except those in the Compensation Committee.

3. Waste

For the same reasons that the Court held that Birmingham failed to adequately plead demand futility for its waste claim, Birmingham also fails to adequately state a claim for waste.

IV. ORDER

For the foregoing reasons, the Court GRANTS Defendants' motion to dismiss WITH LEAVE TO AMEND for failure to plead demand futility and failure to state a claim upon which relief may be granted. Birmingham must file an amended complaint **on or before March 15, 2019**. Failure to meet the deadline to file an amended complaint or failure to cure the deficiencies identified in this Order will result in the dismissal of Plaintiff's claim with prejudice.

IT IS SO ORDERED.

Dated: February 13, 2019

BETH LABSON FREEMAN
United States District Judge